

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 97-0375 ST  
Sales/Use Tax — Capital Cost Reductions  
For Tax Periods: 1994 through 1996**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Sales/Use Tax — Capital Cost Reductions**

**Authority:** IC 6-2.5-5-38.2; IC 9-23-2.5-3  
45 IAC 2.2-4-27

Taxpayer protests the assessment of Indiana sales tax on "trade-in equity" that was given to its customers in lease transactions.

**STATEMENT OF FACTS**

Taxpayer, an automobile dealership, sells and services new and used automobiles. Taxpayer also negotiates automobile leases with its customers. Audit and taxpayer are in disagreement as to the amount of sales tax that should have been collected by taxpayer on some of its vehicle leasing arrangements.

**I. Sales/Use Tax — Capital Cost Reductions**

**DISCUSSION**

As part of its vehicle leasing business, taxpayer negotiates lease agreements with its customers (lessees). Taxpayer then assigns the lease and transfers the vehicle title to an independent lessor. In these transactions, taxpayer collects certain initially required payments upon execution of the lease agreement. However, once assigned, all subsequent lease payments, including sales tax, are made to the third party lessor.

The lease agreements negotiated by taxpayer indicate the capitalized cost of the vehicle. This capitalized cost represents the cost of leasing the vehicle prior to any calculation of monthly payments and taxes. However, before computing the lessee's monthly payments, certain "up-front" payments and credits are allowed with the effect of reducing the lessees' total capitalized cost. These payments and credits – collectively referred to as capitalized cost reductions because they reduce the capitalized cost of the lease – include customer (lessee) down payments, rebates, credit card bonuses, and any net vehicle trade-in allowances. Once the net amount due has been determined (again, the capitalized cost less any capitalized cost reductions) the lessee's monthly payments are then calculated. Included in the lessee's monthly payments – payments made to the lessor – is Indiana sales tax. However, as the capitalized cost reductions are collected or credited by taxpayer prior to the assignment of the lease to the third party lessor, taxpayer is required to collect sales tax on the value of these reductions.

In this instance, taxpayer did collect Indiana sales tax on customer down payments, rebates, and credit card bonuses. However, taxpayer did not collect sales tax on the "trade-in equity" allowed for previously leased vehicles – amounts applied to reduce the capitalized cost of subsequently leased vehicles.

### **Capital cost reductions and vehicle lease transactions**

Taxpayer notes that the issue of capital cost reductions in the context of the acquisition of leased vehicles was recently addressed by the state legislature (statute effective July 1, 1997). Taxpayer directs the Department's attention to Indiana Code § 6-2.5-5-38.2, which states:

The value of an *owned vehicle* is exempt from the Indiana gross retail tax in a *vehicle lease transaction* if the owned vehicle is exchanged for a like kind vehicle. (Emphasis added.)

Taxpayer correctly observes, however, that "[t]he issue of a leased vehicle traded in on a new leased vehicle was not included in th[is] legislation." Such observations have led taxpayer to pray for retrospective relief.

Taxpayer notes that prior to April 25, 1995, the Department's position regarding the taxation of capital cost reductions in the context of vehicle lease transactions was never communicated to the automobile dealer community. Taxpayer argues that information or guidance would have been helpful as this was a relatively "gray" area of the law – at least with regard to the Department's interpretation of that law. Taxpayer further observes that Audit was not pursuing automobile dealers, prior to April 25, 1995, for their failure to collect Indiana sales tax on "trade in" allowances given for *owned vehicles* – allowances which were subsequently applied toward the acquisition of *leased vehicles*. Taxpayer argues that "trade-in equity" allowed for *previously*

*leased vehicles* – allowances which were subsequently applied toward the *lease of other vehicles* – should be treated similarly.

In Indiana, a capitalized cost reduction is defined in IC 9-23-2.5-3 as follows:

“[C]apitalized cost reduction” means a payment made by cash, check, credit card debit, net vehicle trade-in, rebate, or other similar means in the nature of a down payment or credit, made by a retail lessee at the inception of a lease agreement, for the purpose of reducing the capitalized cost and does not include any periodic payments received by the retail lessor at the inception of the lease agreement.

Indiana Administrative Code 45 IAC 2.2-4-27 addresses the taxation of the rental and leasing of tangible personal property. Specifically, 45 IAC 2.2-4-27(c) states, in part:

In general, the gross receipts from renting or leasing tangible personal property are subject to tax. The rental or leasing of tangible personal property constitutes a retail transaction, and every lessor is a retail merchant with respect to such transactions. *The lessor must collect and remit the gross retail tax or use tax on the amount of actual receipts as agent for the state of Indiana...* (Emphasis added.)

The “amount of actual receipts” is defined in 45 IAC 2.2-4-27(1) in the following manner:

The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the business...

Logically, it follows that any capital cost reductions given by the lessor or dealer can not be used to reduce, for Indiana sales and use tax purposes, the gross receipts received from the “leasing of tangible personal property.” Consequently, the total amount received by the dealer or lessor from the lessee for the lease of the vehicle is taxable. This includes amounts characterized as capital cost reductions. Stated another way, although the capitalized cost of a leased vehicle can be reduced (thus affecting the net amount due and the cost of each monthly payment), such reduction does not affect the total amount of the lease transaction, and therefore, the amount of sales tax collected.

So, although the payments and credits received by taxpayer (dealer) which were applied to reduce the capitalized cost of the leased vehicle were taxable, the issue remains whether “trade-in equity” from a *previously leased vehicle* is sufficiently similar to a “trade-in allowance” given for an *owned vehicle* to negate assessments for lease transactions that concluded prior to April 25, 1995. (Note: the enactment of IC 6-2.5-5-38.2, effective July 1, 1997, made this issue moot

*with regard to the taxation of “trade-in allowances” given for owned vehicles which were applied to the acquisition of leased vehicles. Such allowances may no longer be taxed.)*

### **The transactions in question**

The assessments at issue pertain exclusively to the taxation of “trade-in equity” realized from a previous lease transaction which was applied (as a capital cost reduction) toward the new lease of another vehicle.

According to taxpayer, a lessee (the customer) may acquire “trade-in equity” in a leased vehicle in the following manner. Consider the lessee who fulfills the contractual terms of the lease and returns the leased vehicle to the dealer at the conclusion of the lease. After inspection, the dealer values the vehicle at an amount exceeding the lessee’s predetermined purchase price for the vehicle. Such excess is characterized by taxpayer as “trade-in equity.” (Note: a term in the lease agreement affords the lessee an option to purchase the leased vehicle for a predetermined price at the conclusion of the lease.) Similarly, a lessee may also realize “trade-in equity” when the leased vehicle is relinquished to the dealer prior to the end of the lease period.

### **Why these transactions are dissimilar**

So, is the “trade-in equity” realized from the conclusion of a vehicle lease similar, for tax purposes, to the “trade-in allowance” given by automobile dealers for owned vehicles? The answer is no.

For a lessee to realize “trade-in equity” in a leased vehicle, an intervening transaction is required. Two alternate scenarios exist. In the first, the lessee would exercise its option to purchase the vehicle. The lessee – now owner – would then trade-in its owned vehicle toward the lease of another vehicle. The value of such a trade-in would be exempt from sales tax under IC 6-2.5-5-38.2 (effective July 1, 1997) as a like-kind exchange. No evidence, however, has been presented to indicate that the lessees did, in fact, exercise their purchase options and acquire title to their leased vehicles. And even if such evidence were offered, sales tax would be owed (if not collected) on each transaction in which the lessees exercised their purchase options.

The second scenario involves the situation where the current market value of the leased vehicle exceeds the lessee’s pre-determined option purchase price. In this situation, the dealer will credit the lessee with a capitalized cost reduction in the amount of this difference. (The dealer characterizes this difference as “trade-in equity.”) However, under this scenario, the consideration received by the lessee (i.e., the difference) is really equivalent to a taxable cash down payment. Stated conversely, this transaction is neither similar nor analogous to the trade-in of an owned vehicle – a transaction which could have been exempt (at least to the extent of the

value of the trade-in) pursuant to either IC 6-2.5-1-5 or IC 6-2.5-5-38.2. Consequently, under either scenario, Indiana sales tax is owed.

### **FINDINGS**

For the aforementioned reasons, taxpayer's protest is denied.